Essays in Financial Economics

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Abstract

This thesis consists of three essays in financial economics, focusing on topics in banking and corporate finance. Using theoretical models, the thesis attempts to shed light on questions such as how the informational content of corporate financial policy is affected leverage, and whether financial stability can be enhanced using alternative forms of financial intermediation.

The first chapter of the thesis, entitled "*The Importance of Being Prudent: Leverage and the Informational Content of Dividends*," studies how information conveyed by dividend payments is affected by leverage. The conventional view among financial economists is that higher dividends convey good news. For example, higher dividends may signal higher future profitability. In reality, however, financial markets do not always react to dividend increases positively. The chapter proposes a new explanation for why that may be the case. When firms have a lot of outstanding debt and are close to default, they may use dividends to "cash out." In these circumstances, lower, not higher, dividends convey good news. In contrast, when leverage is low, one recovers the classical result that higher dividends send a positive message to financial markets.

The remaining two chapters take a new look at two foundational questions in the theory of banking. First, how does the presence of markets impact the functioning of banks? Second, are there alternative forms of financial intermediation that can do what banks currently do without threatening financial stability?

The second chapter of the thesis, entitled "*Liquidity Creation and Financial Stability: The Role of Hidden Trades*," analyzes how the presence of markets impacts the functioning of banks. The first key result of the paper is that when consumers have access to frictionless markets, mutual funds work just as well as banks in providing liquidity insurance. The second result is that in the presence of such markets, financial panics cannot arise. These results highlight the importance of trading for understanding bank liquidity provision.

The third chapter, entitled "*Aggregate Risk and Efficiency of Mutual Funds*," studies the relative merits of banks and mutual funds in a banking model with aggregate risk. In the aftermath of the global financial crisis, there has been a renewed interest in understanding whether maturity mismatch and the associated financial instability are necessary evils, or whether alternative forms of financial intermediation can perform the same services as banks

at a lower cost to financial stability. In this chapter, mutual funds are shown to perform worse than banks in a setting in which investment returns are risky in the aggregate. In contrast, aggregate risk about liquidity demand is not detrimental to efficiency of mutual funds.

A common thread running through all chapters is a focus on informational frictions and market incompleteness. The thesis attempts to understand the implications of these frictions for the functioning of financial markets and determining what role policy may have in addressing resulting market failures.